EX PARTE OR LATE FILED

Bruce K. Cox
Government Affairs Director

Suite 1000
1120 20th Street, N.W.
Washington, DC 20036
202 457-3686
FAX 202 457-2545
ATTMAIL !bkcox

DOCKET FILE COPY ORIGINAL

September 1, 1994

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, D. C. 20554

Re: Ex Parte Presentation
Docket No. 94-1
Price Cap Performance Review For Local Exchange Carriers

Dear Mr. Caton:

On Thursday September 1, 1994, Rich Clarke, Dick Potter, Paul Malandrakis and I met with Alex Belinfante, Anthony Bush, Dan Grosh, David Nall, Sarah Titus, Mark Uretsky, and Joanne Wall of the Common Carrier Bureau in connection with the above-referenced docket.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's Rules. Due to the lateness of the hour this notice is being filed the next business day.

Sincerely,

Bruce K. Cox

Attachments

cc: Alex Belinfante (without attachments)
Anthony Bush (without attachments)
Dan Grosh (without attachments)
David Nall (without attachments)
Sarah Titus (without attachments)
Mark Uretsky (without attachments)
Joanne Wall (without attachments)

No. of Copies rec'd 0+1
List ABCDE

CC Docket No. 94-1

LEC Price Cap Performance Review:

PRODUCTIVITY ISSUES

AT&T Direct Model

Simple Model

USTA TFP Analysis

Pacific Spreadsheet

Common Line Formula

Cost of Capital Adjustment

Summary

08/31/94

AT&T DIRECT MODEL

PURPOSE

To examine the productivity performance of the RBOCs under Price Cap regulation, and to calculate the "X" value that would have equated their earnings to 11.25%.

AT&T DIRECT MODEL

METHODOLOGY

1. **Calculate Revenue @ 11.25% RoR**

   Compute pro forma financials (adjusting for tax effects) to determine the LEC revenue required to earn an 11.25% RoR.

2. **Calculate PCI @ 11.25% RoR**

   Ratio of revenue at 11.25% RoR to actual revenue (plus under-cap revenue) equals the ratio of PCI at 11.25% RoR to the actual PCI.

3. **Calculate unitary "X" that generates PCI @ 11.25% RoR**

   All components of the PCI at 11.25% RoR are known except "X". The direct model solves for a single "X" which produces PCIs associated with an average 11.25% RoR over the entire price cap period.

AT&T DIRECT MODEL

DATA

1. ARMIS (43-01)

ARMIS data on LEC actual financial performance can be disaggregated to a level which corresponds to the four Price Cap baskets.

2. Annual Tariff Review Plan (TRP) data

Original filed data (on diskettes) was used for LEC price cap parameter values.

3. RBOCs only

- Universe was limited to RBOCs for simplicity – because they generally price regionally and represent over 80% of the price cap industry.
- Inclusion of GTE and other non-RBOC price cap LECs would not alter conclusions significantly.

4. Consistency with Form 492 calculations

ARMIS 43-01 data in the direct model is generally consistent with Form 492 data

- ARMIS data contain a small amount of service data not contained in 492s.
- Computations of Average Net Investment may differ slightly.

SIMPLE MODEL

- Relates changes in RoR to the changes in prices (PCIs) necessary to support these changes in RoR.
- Price/PCI changes easily linked to changes in "X".
- NERA criticism of Simple Model, if implemented correctly, adjusts Simple Model "X" from 6.96% to at least 5.56%.
- NERA criticism of Simple Model has no relevance to the results generated by the Direct Model.

USTA TFP ANALYSIS

- USTA TFP differential is not an "X" for this price cap regulatory plan.
- Fails to adjust for the difference between LEC input price growth and GNPPI – which by itself indicates that a TFP-based "X" would be 5.2%.
- Its measurement of LEC services does not match the price cap plan's measurements of these services.
  - Total LEC vs. interstate access
  - Price and output measurement is inconsistent
  - Depreciation measurement is inconsistent

PACIFIC SPREADSHEET

- Appears to overstate substantially Revenue @ 11.25% (Column I) because of an incorrect implementation of tax gross-up.
- Data on GNPPI, Delta Zs, R, etc. not provided by Pacific, but when TRP data on these parameters are inserted into Pacific's spreadsheet, the resulting "X" is close to 8%.

COMMON LINE FORMULA

- A rationale for the Balanced 50/50 formula was that the extra common line revenue would be used to upgrade loop plant infrastructure.
- Universal Service Fund data compiled by NECA demonstrates that loop costs of price cap LECs have grown faster since the inception of LEC price caps, i.e., 1.95% annually from 1990 to 1992 compared with 0.91% between 1988 and 1990.

(Source: NECA Universal Service Fund Data(10/93))

COST OF CAPITAL ADJUSTMENT

- Weighted average cost of capital computed per Part 65 DCF methodology indicates that LEC cost of capital was 9.93% over the 1991-93 period.
- Because LECs are twice as capital intensive as an average U.S. firm, one half of LEC cost of capital savings was not reflected in GNPPI. (Analysis mirrors that for LEC OPEB calculations.)
- Required rate cut is $322 million.

SUMMARY

- LEC productivity has been in the 5.5% to 6% range for the three-plus years of price caps.
- Because LECs have had to price only to a 3.3% level of "X," LEC RoR has risen by nearly 100 basis points per year.
- The LEC "X" must be reset to reflect this level of actual productivity to restore prospectively the balance between carrier and customer interests.
- A reduction to reflect reduced capital costs is also needed to restore this balance.
- None of these prospective changes would "recapture" any of the excess earnings enjoyed by LEC shareholders over the first four years of price caps.